

The \$50 Billion Threshold in the Dodd-Frank Act: Key Findings

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This *Insight* presents the key findings from the newly issued CRS Report R45036, *Bank Systemic Risk Regulation: The \$50 Billion Threshold in the Dodd-Frank Act*.

Background

The 2007-2009 financial crisis highlighted the problem of “too big to fail” (TBTF) financial institutions—the concept that the failure of a large financial firm could trigger financial instability, which in several cases prompted extraordinary federal assistance to prevent their failure. One pillar of the Dodd-Frank Act’s (P.L. 111-203’s) response to addressing financial stability and ending TBTF was a new enhanced prudential regulatory regime that applies to all banks with more than \$50 billion in assets and to certain other financial institutions. Under this regime, the Federal Reserve is required to apply a number of safety and soundness requirements to large banks that are more stringent than those applied to smaller banks. These requirements are intended to mitigate systemic risk posed by large banks:

- **Stress tests and capital planning** ensure banks hold enough capital to survive a crisis.
- **Living wills** provide a plan to safely wind down a failing bank.
- **Liquidity requirements** ensure that banks are sufficiently liquid if they lose access to funding markets.
- **Counterparty limits** restrict the bank’s exposure to counterparty default.
- **Risk management** requires publicly traded companies to have risk committees on their boards and banks to have chief risk officers.
- **Financial stability**, regulatory interventions that can be taken only if a bank poses a threat to the financial stability.

Most of these requirements apply to about 30 U.S. bank holding companies or the U.S. operations of foreign banks. The requirements do not apply to other types of financial institutions with more than \$50 billion in assets (unless individually designated by the [Financial Stability Oversight Council](#)).

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In addition, a number of provisions, such as higher capital requirements, that stem from the international “[Basel III](#)” agreement apply only to a handful of the largest banks. This is an example of how the current system is tailored, with the largest banks facing more stringent regulatory requirements than medium-sized and smaller banks.

Key Findings

- The specific requirements of enhanced regulation are well-targeted to problems in the financial crisis, but overlap exists between individual provisions that may create excessive regulatory burden.
- Mitigating systemic risk is not the only rationale for enhanced regulation, but it is the primary one. Thus, if banks that do not pose systemic risk are subject to enhanced regulation, costs are imposed on those banks without yielding the primary benefit. The current system is tiered, so regulatory burden is lower in absolute terms for banks near the threshold, but may be higher in relative terms.
- Proponents of enhanced regulation see it as the only realistic option for coping with the risks posed by very large banks, which are a necessary and inevitable feature in financial markets. Although enhanced regulation raises costs, higher costs could theoretically increase economic efficiency if TBTF banks are currently taking excessive risk as a result of the moral hazard problem—if the creditors and counterparties of a TBTF firm believe that the government will protect them from losses, they have less incentive to monitor the firm’s riskiness.
- Opponents fear that regulation will be ineffective and it will increase moral hazard by reducing market discipline. However, any effect enhanced prudential regulation has on market discipline is arguably marginal, because large banks are already subject to a rigorous prudential regulation regime.
- Another possibility is that systemic risk is mainly caused by certain activities, not institutions. Enhanced regulation may not be effective if this is true, and could even exacerbate systemic risk if those activities migrate to less regulated institutions (“shadow banks”).
- Many economists believe that systemic risk is caused by banks that are too interconnected to fail or too complex to fail, as opposed to too big to fail. If size is well correlated with interconnectedness or complexity, then an asset threshold is a simple, inexpensive, and transparent way to determine who is subject to enhanced regulation.
- Data presented in the [report](#) indicate size is not perfectly correlated with interconnectedness or complexity. Some of the eight banks designated as globally systemically important banks (G-SIBs) are not the largest by asset size, and some relatively large banks have relatively low systemic risk indicator scores. No bank with less than \$200 billion receives a high score, but banks under that size have significant activities in at least one of the 12 indicators that make up the score.
- It is difficult to find an asset threshold value that is “just right.” Set too high, the threshold would exclude banks that are systemically important. Set too low, it would include banks that are not systemically important.
- A case-by-case designation process is an alternative to a size threshold. A designation process defers to regulators’ judgment and is inherently more subjective. Designation also risks a greater market perception of official TBTF status. A designation process has been

- used to designate nonbanks as systemically important. That process has proven slow, reversible, and subject to legal challenges in practice. Currently, one firm is designated.
- A hybrid regime that mixes an automatic threshold with a case-by-case designation process reduces—but does not eliminate—some drawbacks to both.
- In addition, Congress could consider various modifications to what types of entities are subject to the regime. For example, the regime could be extended to automatically capture types of depositories that are highly similar to bank holding companies such as thrift holding companies (THCs) and banks without a parent holding company. Today, there are examples of both with over \$50 billion in assets, and there are examples of the former that are complex and predominantly engaged in nonbank activities, such as insurance and investment banking. Looking back, AIG, Lehman Brothers, and Washington Mutual were all THCs at the center of the financial crisis.

Legislative Proposals

Bills to amend which banks are subject to enhanced regulation that have seen legislative action include [H.R. 3312/S. 1893](#), [H.R. 10](#), and [S. 2155](#). A discussion of legislative options can be found in the [report](#).

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